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The Other Path by Hernando De Soto

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THE OTHER PATH. By HERNANDO DE SOTO. New York, New York: Harper & Row Publishers, Inc. 1989. Pp. 271.

Peru is a country undergoing a political, economic, and social crisis.¹ Peru's president since 1985, Alan Garcia Perez, has been an ineffective leader. Garcia Perez lacks the confidence of the people, and his government has "zero credibility."² President Garcia is due to transfer power in July of 1990, but until then the government continues to flounder, and the crisis mounts.³

What direction Peru will take in the future is uncertain. The Peruvian economy is crippled by an eighteen billion dollar debt, making Peru a hostage to its foreign creditors.⁴ In addition to this precarious economic situation is the growing wave of violence perpetrated by drug traffickers and the Maoist guerilla group, the Sendero Luminoso (the Shining Path).⁵ Peru and many of the world's developing countries must overcome giant obstacles in their course of development. Today, development involves the reform of existing political, economic, and social mechanisms. Although the path of reform seems almost impossible, there must be a way to lead Peru and other developing countries toward stability and prosperity.

Hernando De Soto's *The Other Path* offers a path of reform for Peruvian society and for other developing countries that operates outside government laws and regulations.⁶ *The Other Path* is a result of the studies pioneered by the Instituto de Libertad y Democracia (ILD) of which De Soto is president.⁷ De Soto directed the ILD's

* Solicitations Editor, THIRD WORLD LAW JOURNAL.

¹ See Schuck and Litan, *Regulatory Reform in the Third World: The Case of Peru*, 4 YALE J. ON REG. 51, 51-56 (1986).

² Brooke, *Peru Drained By Inflation and Violence*, N.Y. Times, Sept. 18, 1989, at D10, col. 1.

³ *Id.*

⁴ *Id.* at col. 2.

⁵ Schuck and Litan, *supra* note 1, at 55 nn.15-17.

⁶ H. DE SOTO, *THE OTHER PATH* (1989).

⁷ *Id.* De Soto founded the ILD, and it has become a premier research and advocacy organization in Peru. De Soto is a Peruvian entrepreneur who completed his postgraduate studies at the Institut Universitaire des Hautes Etudes in Geneva. He worked as an economist for the General Agreement on Tariffs and Trade. In the 1970's he was appointed by the President of Peru, Fernando Belaunde Terry, to the governing board of Peru's Central Bank, where he served as managing director. De Soto is also director of several Peruvian companies, as well as a member of the United Nations Committee for Development Planning.

research toward an analysis of a phenomenon he termed the “informal sector.”⁸ The informal sector, as opposed to the formal sector, operates outside government laws and regulations. In contrast to Peru’s “‘formal’ legal system, which defines and protects recognized property rights, governs ‘legitimate’ commercial conduct, and adjudicates certain disputes[,]” informal sector activities are conducted outside the legal framework without regard to government regulations.⁹

ILD’s research generated information which fed directly into De Soto’s premise that “this ‘other’ economy, which is not ‘underground’ but in fact operates quite openly, actually constitutes the heart of Peru’s real economic life.”¹⁰ De Soto and the ILD compiled information and statistics on housing, transportation, and trade, and began measuring revenue generated by the informal economy. The data indicated the vast extent of informal activity in Peru, and this led to De Soto’s analysis of informality as an example of the people’s fight for economic rights.

Where others saw clandestine housing and business operations, De Soto saw the poor developing informal alternatives to a formal system which locked them out. De Soto was intrigued by the “economic arrangements” of the informal sector. For example, he took a closer look at the housing arrangements and noticed that “[a]mid the destitution and apparent disorder, enclaves would emerge in which one could observe permanent housing, urban infrastructures, and neighborhood amenities.”¹¹

The Other Path includes a history of the emergence of the Peruvian informal economy, a description of how it operates, and an analysis establishing De Soto’s regulatory reform proposals.¹² De Soto argues that the current government regulations regarding housing, transportation, and trade should be removed, and in their place, the dynamics operating in the informal economy should be allowed to clear the way for capitalism and free market activity, thereby creating a path of “market-oriented reforms.”¹³

Part One of *The Other Path* is a detailed analysis of the inner workings of the informal sector. Housing, trade, and transport are

⁸ Schuck and Litan, *supra* note 1, at 58.

⁹ *Id.*

¹⁰ *Id.* at 59.

¹¹ *Id.* at 57.

¹² See generally H. DE SOTO, *supra* note 6.

¹³ De Soto argues that government regulations impede the growth of the Peruvian economy. *Id.* For a discussion of regulatory reforms and market-oriented reforms in developing countries, see generally, Schuck and Litan, *supra* note 1, at 51–52.

the three major areas in Peruvian society dominated by informality. De Soto uses these three areas to explain how the informal economy began and how it is currently operating. The second part of the book compares the costs of implementing the informal policies with the costs of the formal policies as they currently exist. This review begins by discussing De Soto's view of the informal sector.

I. THE INFORMAL SECTOR

A. *Informal Housing*

For De Soto, informal housing, like other informal activity in Peru, represents an alternative system of urban development.¹⁴ The system developed in response to Lima's unprecedented growth. Lima's population doubled from 2.3 million in 1965 to 4.5 million in 1980.¹⁵ In the last 40 years Lima's urban area has increased by 1,200 percent.¹⁶ This relentless growth is due to the influx of the rural populations to the city. As De Soto explains, these populations have utilized the path of informality in order to establish themselves in Lima.

De Soto explains that informal settlements are the result of two different types of land "invasions"; "gradual invasions" and "violent invasions."¹⁷ "Gradual invasions" occur when the settlers have a previous attachment to the land; for example, when farmworkers or miners who, because of the nature of their work, live on the owner's land, and gradually take over sections of the owner's land. By contrast, "violent invasions" occur when the settlers have no previous attachment to the land they settle.¹⁸

Although "violent invasions" are unexpected by the landowner, they entail a great deal of planning by the settlers. Groups, usually from a particular region, get together and decide when and where to go. The locations are carefully chosen. The groups almost always choose to invade state land. Invasions of state land are more likely to lead to successful settlements because the state is a more passive owner and slower to react than a private owner.¹⁹

¹⁴ H. DE SOTO, *supra* note 6, at 18–19.

¹⁵ Schuck and Litan, *supra* note 1, at 57.

¹⁶ H. DE SOTO, *supra* note 6, at 17.

¹⁷ *Id.* at 19.

¹⁸ *Id.* at 19–20.

¹⁹ *Id.* at 20.

De Soto argues that despite images of land invasions as impromptu illegal land acquisition, there is a plan to the takeovers. The plan is fueled not by an intentional disregard of the law, but rather out of necessity. The ILD's statistics show that informal settlements account for 42.6 percent of all housing in Lima and are home to 47 percent of the city's population.²⁰ Based on these statistics, De Soto further argues that people establish informal settlements "not so [that] they can live in anarchy but so that they can build a different system which respects a minimum of essential rights."²¹ As De Soto explains, the essential rights sought by establishing informal settlements are property rights. Informal settlements, therefore, represent "[t]he people's struggle to acquire private property"²²

De Soto's analysis of informal housing settlements presents a characterization of the settlers as much more than squatters looking for a temporary place to live. The presence and prominence of informal settlements, especially in Lima, is apparent even to the casual observer. It is clear that the informal settlements are not clandestine operations. They are neighborhoods with roads and permanent structures. The extent of the informal settlements in cities like Lima indicates there is "an alternative system of urban development" already operating in Peru.²³

Housing is one of the most difficult problems facing developing countries today.²⁴ The population explosion under way in developing countries has resulted in unprecedented urbanization. Because of the erratic and unstable economies of many developing countries, government efforts to solve housing problems have been largely ineffective.²⁵

The existence of informal settlements in Peru reflects the government's inability to provide housing or land. The housing shortage is an overwhelming problem. De Soto's proposal to utilize the system of property rights operating in informal settlements is the first step, but it may not go far enough in ensuring that the right to housing of all individuals is guaranteed. Reform of the housing problem cannot be left entirely to informal dynamics.

²⁰ *Id.* at 13.

²¹ *Id.* at 55.

²² *Id.*

²³ *Id.* at 19, 55.

²⁴ Smith, *Housing the Urban Poor in Developing Countries: Selected Legal Issues in the Provision of Serviced Land and Shelter*, 10 GA. J. INT'L & COMP. L. 527, 584 (1980).

²⁵ *Id.*

Informality must be balanced with the streamlining, updating, and improvement of existing government policies. De Soto suggests that archaic government controls on the acquisition of legal title to land should be eliminated.²⁶ On the other hand, government programs aimed at controlling problems like overpopulation should be strengthened, since overpopulation is one of the main sources of the housing crisis.²⁷ Only through this dual approach will the advances made by adopting informality be ensured. Together, informality and well-administered formal programs can guarantee housing for all individuals.

B. *Informal Trade*

De Soto describes informal trade as another alternative the people of Peru have devised in order to secure their right to private property. De Soto separates informal trade in Peru into two categories, street vendors and informal markets. The numbers which De Soto and the ILD arrived at are astounding. According to their statistics, 314,000 people are dependent on street vending, and 125,000 people are dependent on informal markets.²⁸ Both the street vendors and the informal markets are predominant in the informal settlements, and they both maintain successful operations. For example, the street vendors make a net per capita income of \$58 a month, which is 38 percent more than the minimum legal wage.²⁹

De Soto explains, however, that the street vendors have low productivity because they offer only a limited range of goods and services.³⁰ The street vendor's business is further hampered by the inability to offer any customer-related services or any credit. Furthermore, their business exists without any proper storage mechanisms or safety systems. These restrictions have led to the creation of informal markets.³¹

By conducting their business through the establishment of an informal market, informal vendors "aspir[e] to obtain secure private property in order to conduct business in a favorable environment."³²

²⁶ *Id.*

²⁷ *Id.*

²⁸ H. DE SOTO, *supra* note 6, at 60-61.

²⁹ *Id.* at 61.

³⁰ *Id.* at 72.

³¹ *Id.*

³² *Id.* at 91.

De Soto explains that the interest of the informal traders lies in attaining property rights. Once they acquire property rights the vendors can “. . . preserve resources, stimulate production, and guarantee the inviolability of investments and savings.”³³

De Soto's analysis of informality works exceptionally well when applied to reform of trade in Peru. In no other area is the need to cut back government regulation so apparent. The failure of the government's economic reform policies have virtually shut down economic growth in the formal sector.³⁴ Economic activity is stagnant, and there is a large percentage of capital being transferred out of Peru.³⁵ The economic reform policies have failed on many levels. For example, in 1985 the Garcia Perez government created a new currency, the *inti*, to replace the *sol*, which was prone to inflation. Today a 10,000 *inti* note is worth less than three US dollars, and *intis* are “treated like trash.”³⁶

In addition to failing to revive the economy, the government's policies have hindered the growth of the formal economy by shutting out the economic activity of the informal economy. Instead of condemning the onslaught of informality, the government should recognize informality. By loosening restrictions and cutting bureaucracy, informal trade and informal markets will expand, and their incorporation into the formal economy will benefit both sectors of the economy. Many economists agree that the survival of the Peruvian economy depends on the implementation of “enlightened economic policies.”³⁷ According to Peruvian economists Carlos E. Paredes and Hernan Garrido-Lecca, such policies would include “privatizing state-owned industries that have heavy losses.”³⁸ Clearly, business activity in Peru needs the activity operating in the informal economy, and those individuals working within the informal economy should be granted the formal property rights they deserve.

C. *Informal Transportation*

De Soto uses the expansion of informal transport to illustrate the informal sector's creativity and entrepreneurship. Informal

³³ *Id.*

³⁴ See Brooke, *supra* note 2.

³⁵ *Id.* at col. 3.

³⁶ *Id.* at col. 1.

³⁷ *Id.* at col. 3.

³⁸ *Id.* at col. 2.

transport expanded as a result of the expansion of informal housing and informal trade.

There are two types of informal transport in Lima. The first type is known as the "collective" transport and consists of taxis, sedans or station wagons, which carry an average of five to eight people. The second type of informal transport is the "minibus." These buses range from small Volkswagon minivans, which hold from eight to twelve people, to large buses which hold more than 80 people.³⁹ Informal transport covers routes throughout the city of Lima. In order to strengthen the operation of the informal transport system, the operators of the vehicles have organized themselves into various groups. These organizations serve to further the interests of the drivers, and of the informal transport system in general. By 1984 the informal vehicles in service accounted for 91 out of every 100 vehicles, and public transportation depended almost entirely on informal transportation.⁴⁰

The ILD estimates that in 1984 91 percent of the 16,228 vehicles used for mass transit were being operated informally.⁴¹ De Soto explains, "[t]he fact that informality accounts for such a large proportion of mass transit means that, as in informal settlements and informal trade, a complex system of economic and legal relations must first have developed to permit the subsequent evolution."⁴²

De Soto's analysis of informal transportation in Lima is the best illustration of the success of the informal economy. Informal transportation dominates public transportation in Lima. Without informal transportation there would be virtually no public transportation.

Informal transportation, like informal housing, is a direct result of the rapid urbanization of developing countries, and is one of the problems governments of developing countries repeatedly fail to solve. It is clear that "policies whereby public systems can be more efficiently managed" must be developed.⁴³ The management and operation of informal transportation in Lima is so widespread and so well administered that it can serve as a model to the government.

³⁹ H. DE SOTO, *supra* note 6, at 94.

⁴⁰ *Id.* at 95, 99-100.

⁴¹ *Id.* at 93.

⁴² *Id.* at 94.

⁴³ Smith, *supra* note 24, at 583.

II. THE LEGAL IMPEDIMENTS OF THE FORMAL SECTOR

In Part Two of *The Other Path* Hernando De Soto analyzes the Peruvian legal system by comparing the costs of formality and the costs of informality. Throughout his analysis De Soto measures the role of the law as it relates to both formality and informality. De Soto explains that the law has a direct effect on the “efficiency of the economic activities it regulates.”⁴⁴ De Soto further explains that “a law is ‘good’ if it guarantees and promotes economic efficiency and ‘bad’ if it impedes or disrupts it. The *unnecessary* costs of formality derive fundamentally from a bad law; the costs of informality result from the absence of a good law.”⁴⁵

One way De Soto measures the effect of the law on the informal sector is by using the resources of the ILD to attempt to set up various small businesses through legitimate channels. Each time, the ILD was stalled by the government bureaucracy. The ILD resisted paying bribes, but in the end was forced to do so in order to continue the process of establishing the small business. The ILD found that the time and money spent in trying to establish a small business demonstrated the formal sector’s ignorance of the situation of poor people in Peru. It is only by working within the informal sector that poor people are able to put their skills to work immediately. As De Soto explains, these people “have chosen to operate outside these bad laws, which entail such high costs and such complex regulations.”⁴⁶

De Soto’s analysis of “good” laws versus “bad” laws provides the framework for understanding his argument that the informal economy in Peru is really the heart of Peru’s economic life. More importantly, however, this analysis provides the necessary framework for understanding the steps that need to be taken in developing the path that the informals have established.

Here, De Soto increases the viability of his proposals by acknowledging the need for a balance between informality and formality. De Soto goes beyond simply exalting the triumphs of informality, and explains that the government must enact “good” laws. According to De Soto these “good” laws must “create incentives for people to seize the economic and social opportunities offered by

⁴⁴ H. DE SOTO, *supra* note 6, at 132.

⁴⁵ *Id.*

⁴⁶ *Id.* at 182.

the country," and they "must facilitate the specialization and interdependence of individuals and resources."⁴⁷ In effect, De Soto is proposing a formal system of laws. This formal system of laws would, however, be based on promoting and facilitating economic activity. Although De Soto's formal system mirrors informality, he is nonetheless suggesting the need for central regulatory reforms.

De Soto argues that despite the traditional belief that economic achievements are the cause of development, the real cause of development is ". . . an official set of legal and administrative institutions which encourages technical progress, specialization, exchanges, and investment."⁴⁸ Furthermore, De Soto argues "[i]t is because of bad laws, then, that both formals and informals are only incipient, interdependent specialists whose potentialities will remain limited as long as the state fails to give them the incentives needed for progress, namely good laws."⁴⁹

III. CONCLUSION

Hernando De Soto's proposals are ambitious. Yet, they are convincing especially when questioning and challenging the government's regulatory reforms. The ILD's statistics and studies show that the Peruvian government's administrative and legislative procedures and regulations hamper rather than facilitate economic growth. Furthermore, all the economic indicators in Peru paint a bleak picture. Since 1981, Peru's Gross Domestic Product has dropped approximately forty percent, half the population is unemployed or underemployed, and prices of export goods are down an average of thirty-five percent.⁵⁰

Clearly, reform of the operating economic programs is crucial, but will this be enough to achieve political stability and greater social justice? De Soto suggests that the path mapped out by the informal sector is in fact the only way to achieve these goals. De Soto calls for change and reform based on the dynamics already being played out in the informal sector. The need for a new path has already been recognized by the poorest of the Peruvian population. They have successfully established housing, employment, and transportation systems throughout Peru to meet their needs. Mario Vargas Llosa, currently a candidate for the Peruvian presidency, captures

⁴⁷ *Id.*

⁴⁸ *Id.* at 184.

⁴⁹ *Id.*

⁵⁰ Schuck and Litan, *supra* note 1, at 54.

De Soto's underlying philosophy when he states in the Foreword of *The Other Path* that "the revolution this study analyzes and defends is . . . already under way, made a reality by an army of the current system's victims, who have revolted out of a desire to work and have a place to live and who, in doing so, have discovered the benefits of freedom."⁵¹

⁵¹ H. DE SOTO, *supra* note 6, at xxii.